M e m o r a n d u m

To: Honorable John Chiang, Chair
Honorable Claude Parrish, Vice-Chairman
Ms. Betty T. Yee, Acting Board Member
Honorable Bill Leonard
Honorable Steve Westly

Date: March 29, 2005

From: David J. Gau, Deputy Director
Property and Special Taxes Department

Subject: ***Application of Proposition 13's Annual Inflation Adjustment to Properties Reconstructed Following a Disaster***
(April 12, 2005 Property Tax Committee Meeting)

Introduction

At the March 9, 2005 Board meeting in Culver City, San Bernardino County Assessor Don Williamson raised an issue about the adjustment of the base year value of property damaged or destroyed by a disaster during the period prior to reconstruction when the base year value is restored. Specifically, Mr. Williamson stated his position that once a damaged or destroyed property has received a temporary reduction in assessment under Revenue and Taxation Code section 170, upon reconstruction of the property the base year value to be re-enrolled should not include any inflation factoring for assessment years in the interim between the damage and the reconstruction.

The Board decided to hear a presentation of the issue at the April 2005 meeting of the Property Tax Committee. For the Committee's information, this memo discusses (1) the relevant portion of section 170; (2) the meaning of the term "factored base year value;" (3) the longstanding application of inflation factoring to properties reassessed under section 170; (4) alternatives for implementing Mr. Williamson's interpretation; (5) other provisions that provide similar relief; and (6) an issue of equity between property owners.

Section 170

Section 170 is the legislative implementation of article XIII, section 15 of the California Constitution, which gives the Legislature the power to "authorize local government to provide for the assessment or reassessment of taxable property physically damaged or destroyed after the lien date to which the assessment or reassessment relates." Section 170 contains provisions aimed at the assessment treatment of damaged or destroyed property in California's post-1978 local property tax system, which is, in general, governed by Proposition 13.[1]

Section 170 authorizes the assessor to make an immediate reduction in the *assessed value* of damaged property, in proportion to the percentage of *market value* lost as a result of the damage.[2] The reduced value, subject to annual adjustments for inflation, remains on the assessment roll until such time as the property is reconstructed.[3] Once reconstruction is complete (and assuming the reconstructed property is essentially equivalent to the property prior to the damage or destruction) the property is assigned a "new taxable value." Under section 170, subdivision (h), the "new taxable value" is defined as "the lesser of the property's (A) full cash value, or (B) factored base year value or its factored base year value as adjusted pursuant to subdivision (c) of Section 70." Thus, the resolution of the issue brought by Mr. Williamson turns on the meaning of the term "factored base year value" as applied to properties damaged or destroyed by disaster.

Meaning of "Factored Base Year Value"

The term "factored base year value" refers to a property's market value as of the latest change in ownership or completion of new construction, adjusted to reflect annual changes in California's Consumer Price Index. The inflation *factor*, announced annually by the Board, reflects the percentage change in the index over the previous year. Existing base year values are multiplied by the current year's factor, which is expressed in numerical terms.[4] Under Proposition 13, in no event may the factor increase the existing base year value (adjusted for prior years' changes in the index) by more than 2 percent.[5]

The property's factored base year value places a ceiling on its taxable value. Under Revenue and Taxation Code section 51(a), the assessed value of a property subject to Proposition 13 is the *lesser* of either (1) its current fair market value or (2) its factored base year value. Thus, although a property is generally assessed at its factored base year value, the factored base year value is not

[1] Section 170 is applicable only in counties whose boards of supervisors have adopted an authorizing ordinance. Currently, 57 of the 58 counties have such ordinances in place.

[2] A simple example illustrates the treatment. Assume locally assessed property, valued under Proposition 13, carries a factored base year value for improvements of $150,000 for the 2003 assessment year. The improvements, which have an estimated *market* value of $250,000 on January 1, 2003, lose 50 percent of their market value in a disaster occurring on October 1, 2003. Under section 170, the reduced assessment for the improvements would be $150,000 x 50 percent, or $75,000.

[3] See section 170, subdivision (h), which provides that "[t]he assessed value of the property in its damaged condition, as determined pursuant to subdivision (b) compounded annually by the inflation factor specified in subdivision (a) of Section 51, shall be the taxable value of the property until it is restored, repaired, reconstructed or other provisions of the law require the establishment of a new base year value."

[4] For example, for assessment year 2004 the Board announced an annual inflation factor of 1.01867. This factor, multiplied by an existing base year value of $100,000, would result in a 2004 factored base year value of $101,867.

[5] Of course, such annual changes can, theoretically, be either positive or negative, and so the annual "inflation" factor, as announced by the Board and applied to a property's existing base year value, may result in either increases or decreases to that value. Proposition 13's only limitation on the adjustment is that it may not *exceed* 2 percent; there is no corresponding limitation on a downward adjustment. Thus, in a deflationary period, there would be no limit to the amount by which the existing base year value could be *decreased* as a result of the application of the factor.

the property's assessed value per se. Rather, it is a control figure that *limits* the property's assessed value. Moreover, there is no provision, either in section 170 or elsewhere in the law, that would allow for the suspension of the inflation factoring that is annually applied to this control figure.

Application of the Inflation Factor Under Section 170

In 1979, the Task Force on Property Tax Administration ("Task Force") issued a report entitled *Property Tax Assessment: Implementation of Proposition 13*.[6] The report contained detailed recommendations, including one that specifically dealt with the application of the inflation factor to properties suffering damage or destruction as the result of a disaster. The Task Force illustrated its recommended application with a chart and an accompanying narrative (see Attachment A).

The Task Force's view was that, upon reconstruction of property following a disaster-related reduction in assessment, the factored base year value to be re-enrolled would *include* inflation factoring for assessment years in the interim between the disaster and the reconstruction. Following the issuance of the report, the Legislature enacted measures to implement the Task Force's recommendations, and for more than 25 years the Board's advice on this issue has been consistent with the Task Force's recommended treatment.[7]

In addition to section 170, the clear guidance of the Task Force has been followed by the Legislature in sections 69, 69.3, and 69.4. Those sections provide for property tax relief by allowing a property owner whose property has been damaged or destroyed to transfer the base year value from the original property to a replacement property under specified circumstances. Each of those sections provides that the base year value to be transferred includes inflation factoring in the interim period between the time of the event and the acquisition of the replacement property.

Alternatives

In order to apply Mr. Williamson's interpretation, the Legislature must amend section 170 to allow for the suspension of annual inflation factoring. Since the plain language of the statute and the legislative history on this issue is unambiguous, an amendment to a Board rule is not a viable alternative, inasmuch as such a rule amendment would be inconsistent with the statute.

Other Disaster Relief Provisions

If the Board were to sponsor an amendment to section 170, it might also wish to consider sponsoring parallel amendments to sections 69, 69.3, and 69.4.

Sections 69 and 69.3 both provide relief for owners of property damaged or destroyed in a disaster as declared by the Governor. Under certain conditions these sections allow the base year

---

[6] The Task Force, which was formed at the behest of the Assembly Revenue and Taxation Committee immediately following the passage of Proposition 13, was a broad-based group of state and local policymakers, property tax administrators, and taxpayers.

[7] See, for example, Letter To Assessors Nos. 82/12 and 95/31; and Assessors' Handbook Section 501, *Basic Appraisal*, pp. 140-141.

value of the damaged or destroyed property to be transferred to a replacement property in another location. Both of these sections make clear that the base year value to be transferred includes adjustments for inflation factoring during the interim period between the date of the damage and the acquisition of the replacement property. Thus, for the sake of consistency, if the Board wishes to sponsor amendments to section 170 to apply Mr. Williamson's interpretation, it might also wish to sponsor amendments to sections 69 and 69.3.

Similarly, section 69.4 provides relief for properties impacted by environmental contamination. Under certain conditions, this section allows the base year value of the contaminated property to be transferred to a replacement property. Like section 170 and sections 69 and 69.3, section 69.4 makes clear that the base year value to be transferred includes inflation factoring in the interim period between the time of the contamination and the acquisition of the replacement property. Thus, if the Board wishes to sponsor amendments to section 170 to apply Mr. Williamson's interpretation, it might also wish to sponsor amendments to section 69.4.

Tax Equity

In staff's view, Mr. Williamson's interpretation would result in inequitable tax treatment of otherwise similar properties. An example illustrates the problem.

Assume two comparable properties, A and B, located next door. For assessment year 2003, each property has a total factored base year value of $300,000, from which $200,000 is allocated to land and the remainder to improvements. Since each property's factored base year value is less than its market value, a taxable value of $300,000 is enrolled.

On October 1, 2003, the improvements on Property A are completely destroyed by fire, but Property B is undamaged. The assessor performs a reassessment of Property A pursuant to section 170, and reduces the assessed value of the improvements to zero. The owner of Property A receives a pro rata refund of any taxes paid based on the property's taxable value prior to the damage.

In subsequent assessment years, Property A continues to have a reduced assessment, to reflect the destroyed improvements, and its base year value of the improvements is not factored for inflation. The base year value of Property B continues to be factored and the property is annually assessed at the lesser of its market value or its factored base year value. Finally, six years later, in 2009, the owner of Property A completes a reconstruction such that the improvements are equivalent to those that stood prior to the fire.

Assuming Property B's factored base year value is less than its market value in 2009 (and assuming an annual inflation factor of 2 percent for each year) its assessed value is $\$300{,}000 \times (1.02)^6 = \$337{,}849$. By contrast, if the law were changed such that that the factored base year value of Property A were not subject to the inflation factoring currently required by section 170, the total assessed value of Property A would be $\$100{,}000 \times (1.02)^6 + \$200{,}000 = \$312{,}616$.

As a result of Mr. Williamson's interpretation, the total factored base year value of Property A would be substantially lower than that of Property B. Thus, Property A would receive not only a temporary reduction in value, but in effect a permanent reduction in the base year value when compared with Property B. In the staff's view, a temporary tax reduction is a reasonable means of affording equitable tax treatment for property that is unusable or nonexistent due to damage or destruction. However, Mr. Williamson's proposal creates inequity by establishing a permanent tax reduction for property that no longer suffers from damage or destruction.

DJG:sk
Attachment

Attachment A
Excerpt

IMPLEMENTATION OF PROPOSITION 13

VOLUME I

PROPERTY TAX ASSESSMENT

OCTOBER 29, 1979

Prepared By Staff Of The

ASSEMBLY REVENUE AND TAXATION COMMITTEE

WILLIE L. BROWN, JR.
Chairman

No. 748

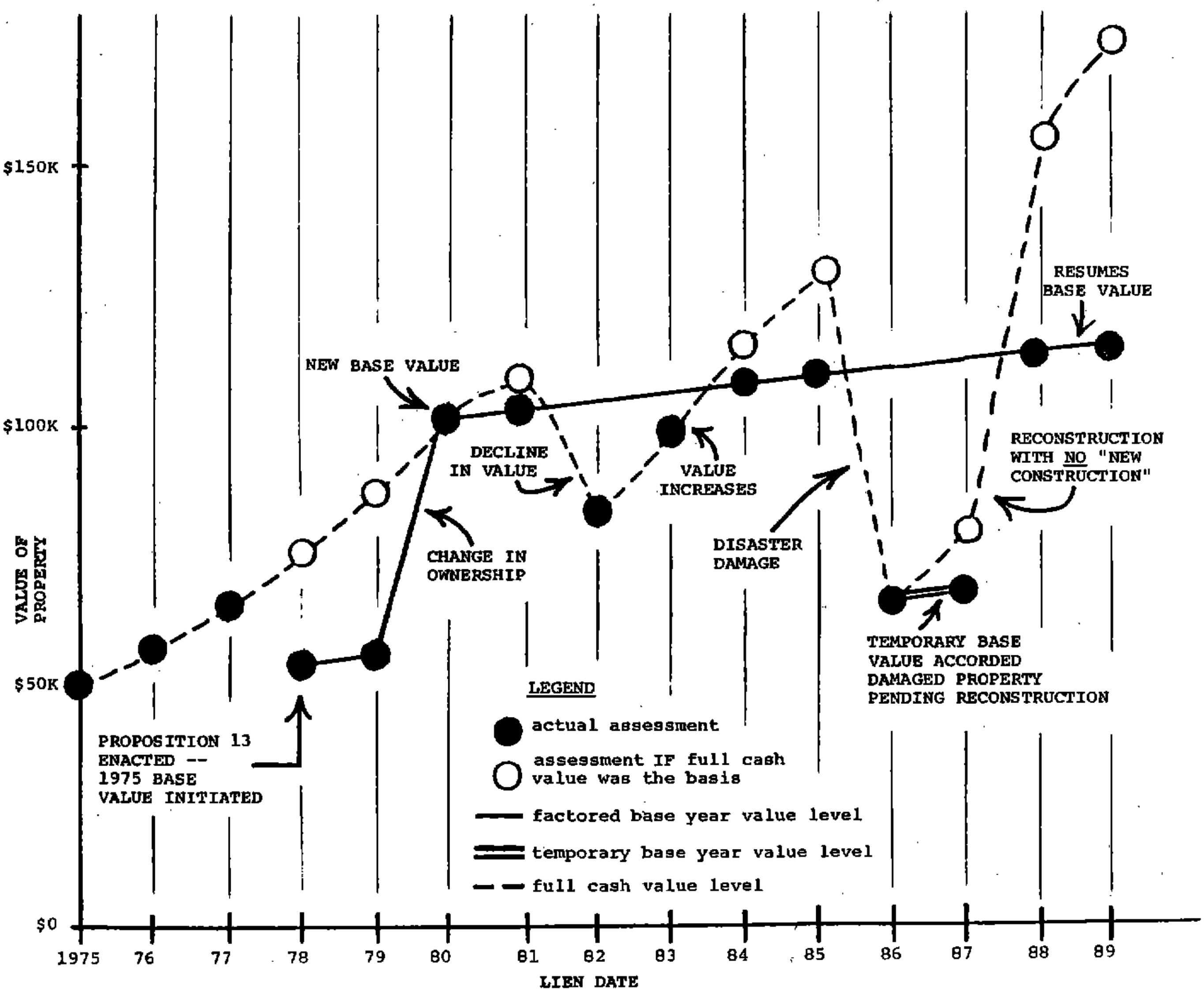
TABLE IV

VALUE CHANGES FOR A SAMPLE PROPERTY

OVER A PERIOD OF YEARS

Explanation of Table

The table below illustrates the changes in value for a hypothetical property from 1975 to 1977 (pre-Proposition 13) and from 1978 to 1989 under the present legislation implementing Prop. 13. Shown are the effects of a change in ownership, a decline in value, and value changes due to a disaster and subsequent reconstruction. The table charts the relative levels of full cash versus factored base year values, while the narrative on the facing page explains the hypothetical details to these various changes in value.



Narrative

NOTE: The following values and percentages are purely illustrative, to show the workings of the assessment system given different types of value increases and declines.

1. Pre-Prop. 13 values of the hypothetical property were increasing at 15% per year (1975: $50,000; 1976: $57,500; 1977: $66,125).

2. Proposition 13 takes effect for the 1978 lien date, rolling back the property's value to $53,060--1975 value compounded at 2% annually. (Full cash value would have been $76,044, at 15% increase over the previous year's full cash value.)

3. Value on 1979 lien date is 2% higher than previous year ($54,122), whereas full cash value would have been $87,450 at a 15% increase.

4. In 1979 the property is sold, and as a change in ownership a new base value is established for 1980, which is equal to the full cash value, at $100,568 (15% increase).

5. The 1981 value is 2% higher, at $102,529. Full cash value begins slipping, and increases by only 5%, because of a downturn in neighborhood economic conditions, to $105,596.

6. In 1982 the full cash value falls by 20% to $84,477. Since the full cash value is now <u>lower</u> than the factored base value, which continues to <u>increase by 2%</u> annually, this lower value is used. This does <u>not</u> establish a new base value.

7. By 1983 conditions in the neighborhood are improving, and a 10% increase in full cash value is registered. This value of $92,923 is still less than the factored base value of $106,724, so full cash value remains the basis for the assessment. Note that the increase of 10% is <u>greater</u> than the <u>2%</u> allowable increase in base year values. <u>Full cash value is</u> not so constrained, however the assessment cannot <u>exceed</u> the factored base value.

8. In 1984 full cash value increases by 20% to $111,508 which exceeds the factored base value of $108,858, so the latter is the assessment.

9. The factored base year continues to increase by 2% to $117,035 (chart is not quite to scale here).

10. Disaster strikes in 1986. A fire reduces the full cash value of the property ($122,659) by 50%, so the factored base value is also halved, from $113,256 to $56,628.

11. No reconstruction is undertaken in 1987, so a <u>temporary</u> base value is established, and the value increases <u>only 2%</u> over the prior year even though the full cash value of the property increased by a greater percentage to $60,000.

12. By lien date 1988 the property is reconstructed, and is comparable to the pre-disaster condition. Thus, no "new construction" is deemed to exist, and the <u>prior</u> base year value is reapplied, with accumulated <u>inflation</u> factors, which is $117,831. If full cash value were used, the property would be assessed at $150,000, because it increased by 250% on the open market.

13. The example ends in 1989 with the property once again on the factored base value track with a 2% increase over the prior year, while the full cash value continues to soar.